CHEMICAL BANKING Corporation

MANUFACTURERS HANOVER

Economic Report

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Commentary on Pertinent Economic Issues

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The Only Thing We Have To Fear...

The gloom enveloping the United States economy these days is so thick you could cut it with a knife. Survey after survey shows confidence declining—and with it, the President's standing among the electorate. Most people are afraid of losing their jobs; many know someone who either has become unemployed, or is unable to work in the field for which he or she is qualified. Then there are the dropouts from the workforce; blue collar workers are known as "discouraged" workers, while white collar workers have become "consultants."

Intensifying these fears were the layoff announcements late last year by several major companies. Not only did these make the front pages of the daily papers and the top of the evening news stories on radio and television, they got many people whose jobs might otherwise be secure to figure that "if these blue-chip firms are letting people go, what hope is there for the rest of us—including me?" And by playing up these negative stories, while downplaying such positive stories as new plant openings and hirings, the press probably contributed to this malaise as well.

Little wonder that the 1991 Holiday shopping season was disappointing. Not only did sales in November and December decline, seasonally adjusted, but merchants' results for the full year were the worst since the Government began keeping records 25 years ago. In their negative frame of mind, consumers confined their spending to those items they had to buy; they searched for the least expensive version from the lowest-priced outlet. Needless to say, this cast a pall on retailers' willingness and ability to order merchandise for the next selling season, which, of course, has depressed activity among suppliers.

Economics Department
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The Numbers Aren't That Bad

Are things really as bad as people think? Or will it turn out that the only thing we have to fear is fear itself? To put it another way, there are far more positive statistics than there are negative numbers—but if the public's mood doesn't brighten soon, we could well talk ourselves into something far worse than we've actually experienced.

After examining the data carefully, even the gloomiest analyst would have to admit that—whatever you call this period, it certainly does not contain the characteristics of a severe slump, much less the "free fall" described by the President in a recent campaign swing through New Hampshire. Indeed, regardless of when the recession "officially" ended, the year 1991 contained many bright spots:

- New-home construction and sales jumped more than 26 percent;
- New orders for durable goods have risen ten percent since March—with nondefense capital goods bookings soaring more than 25 percent since May;
- Total business shipments increased for eight consecutive months—the first time this has happened since 1983, when the economy was emerging from the last recession;
- Inflation-adjusted exports have gone up by 12½ percent since February, helping manufacturing production to rise one percent last year, after falling by about that much during the previous year;
- Business inventories are back in line with sales, with a ratio of 1.50, while in the key and cyclical manufacturing sector, the inventory-sales ratio, at 1.53, is now at a 12½-year low;
- Consumers are saving over five percent of their take-home pay—more than they did during the years 1987-91;
- Use of debt has declined over the past year, bringing the ratio of consumer installment debt outstanding to disposable personal incomes down to 17 percent—about the lowest in six years;
- Buying power is beginning to grow, since inflation at the producer level disappeared last year, and ran at a five-year low of only three percent at the consumer level;
- The unemployment rate averaged 6.7 percent in 1991—lower than in every month from April 1980 through November 1986 except for January 1986, when it was also 6.7 percent;
- Employment actually rose by 237,000 in the

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last three months of 1991, but since it normally goes up by about 464,000 during this period, it was reported as a decline of 227,000, after seasonal adjustment.

Most of these statistics, along with several others, are incorporated in the gross domestic product, the all-encompassing measure of what is produced within our borders. Government calculations show that the GDP rose in the second, third and fourth quarters of last year; this is why many believe that the recession, which "officially" began in August 1990, probably came to an end in April or May of 1991. For never before in the postwar era has a recession been interrupted by three back-to-back growth quarters.

To these favorable developments should be added:

The 25 percent jump in stock prices over the past year. This kind of an increase helps the economy in three ways: (1) by adding to general confidence levels; (2) by making shareholders wealthier, thus able to spend more; (3) by enabling publicly-held companies to raise more money for a given dilution of equity.

The 21 percent drop in oil prices since October. Since everyone uses oil in some form—whether for gasoline, to transport goods, heating, producing electric power or as a feedstock for plastics and clothing—this kind of a drop will leave people and business with more money for either paying down debt, boosting savings or spending.

The halving of interest rates over the past 12 months. This obviously hurts savers, especially retired people, but it does enable borrowers—usually younger people and businessmen—to pay less, either through an interest rate that floats downward, or through refinancing an existing fixed-rated loan.

By now, it should be clear to the reader that everything is in place for an improvement in the pace of business activity this year. All that's needed is for the consumer to regain confidence. But herein lies the problem—you cannot order people to be more confident when they fear for their jobs any more than you can order business *not* to manage for the bottom line, which means cutting staff when cost reductions become necessary.

People Have Lots of Worries

One of the reasons why people got so depressed late last year was a feeling that Washington either didn't recognize that the economy needed help and/or didn't have a plan to rectify it. The last issue of this Report offered a number of suggestions, some of which were incorporated in the President's State of the Union address. The very fact that the President has turned his attention back to domestic affairs should help boost confidence in and of itself.

But it will take more than words to shake people out of their lethargy. For they are also depressed by such other factors as the decline in the value of their biggest asset, their home, still-high debt loads, soaring health care costs, difficulty in maintaining living standards since many state and local taxes, tolls and transit fares keep going up, lack of jobs for young people just out of school, and our decaying physical and social infrastructure.

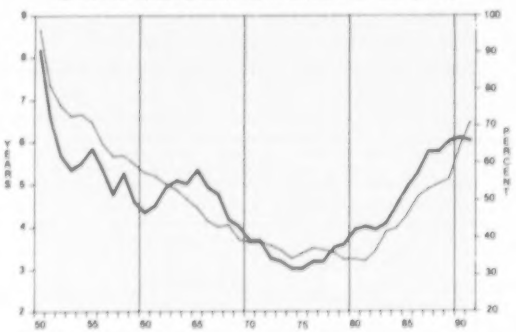
To these must be added a few personal fears. Take monetary policy, for example. When the Federal Reserve departed from its previous policy of small cuts in interest rates and slashed its discount rate by a full percentage point on December 20, it was even more significant than it looked. True, it was the largest point drop for this key rate in ten years. However, in 1981 rates were almost three times higher; 1991's one-point decline from 4½ percent to 3½ percent represented the fourth largest *relative* cut in history. The other three all took place during the Great Depression!

To drive rates down this fast required a sizable injection of reserves into the banking system, for the Fed had to supply more funds than the banks needed in order to push down their price. As a consequence, bank reserves are now growing at a yearly clip of over nine percent—the fastest rate of increase in more than four years . And while this has yet to translate into rapid money growth (M2 last year barely hit the Fed's minimum target of a 2½ percent increase), this is only because the low level of interest rates has caused people to withdraw funds from the banking system as their certificates of deposit mature, looking for higher yields elsewhere. M2 excluding these small CDs grew a whopping 8¾ percent last year—almost twice the 4½ percent it logged in during 1990.

In other words, there's a lot of liquidity that's beginning to slosh around in the financial system—even if it has yet to show up in the nation's money supply. When it does, it could rekindle the fires of inflation, which right now are banked.

Latent fears of inflation are one reason why long-term interest rates have not declined as much as those on shorter-dated instruments. The bond markets are always concerned about inflation and what it might do to the value of a long-term investment. This has resulted in an unusually wide gap between short- and long-term interest rates, known in the jargon as a steeply sloped yield curve. To "twist" this curve so that long rates come down, the Treasury has hinted that it might restrict sales of its longer-dated bonds, thereby creating somewhat of a scarcity, which, in turn, would drive down their yields by pushing up their prices.

AVERAGE MATURITY OF FEDERAL GOVERNMENT DEBT (THICK) VS. TOTAL FEDERAL DEBT AS A PERCENT OF GDP (THIN)



Source: Treasury Department

This may not work. As the chart indicates, the Government's debt is now so large relative to the economy that concentrating on selling shorter-dated issues may result in significantly higher interest rates on Treasury bills and notes. Trade is another concern of mine. The President's recent trip to Asia spotlighted our trade deficit—especially with Japan and the newly-industrialized countries (NICs) of the Pacific Basin. In this regard, several points should be noted. First, our trade deficit with Japan has declined by 25 percent since the end of 1987, but has remained the same against the NICs, while rising 17 percent with the Organization of Petroleum Exporting Countries.

The second point has to do with our trade deficit and the state of our economy. Our overall trade gap was much larger in the mid-1980s than it is today—yet the GDP was growing much faster then. From another angle, exports fell from mid-1985 through the first few months of 1986 while the GDP was climbing; today, exports are growing at the fastest rate in two years, yet GDP's growth is down.

I am also concerned that some people don't quite realize the main purpose of trade between two countries. It is not, as has been suggested, that if we buy one country's products, that country should reciprocate by purchasing the same ones from us. There is not much point in doing this. In reality, as economists have maintained for nearly two hundred years, the purpose of international trade is that it be mutually beneficial. In other words, countries should import what they don't have, or aren't good at making, and export what they do have, or are good at making. In the literature this is known as the "doctrine of comparative advantage."

For example, if a country is better at making consumer electronics than airplanes, it should concentrate on making consumer electronics, exporting enough of them to pay for imports of planes. This would apply even if it happened to be the world's best producer of planes; as long as it can make consumer electronic goods better than it can manufacture planes, it will come out ahead by specializing in what it is comparatively good at, and importing the other. This allows countries to trade even if they are not the absolute best at anything.

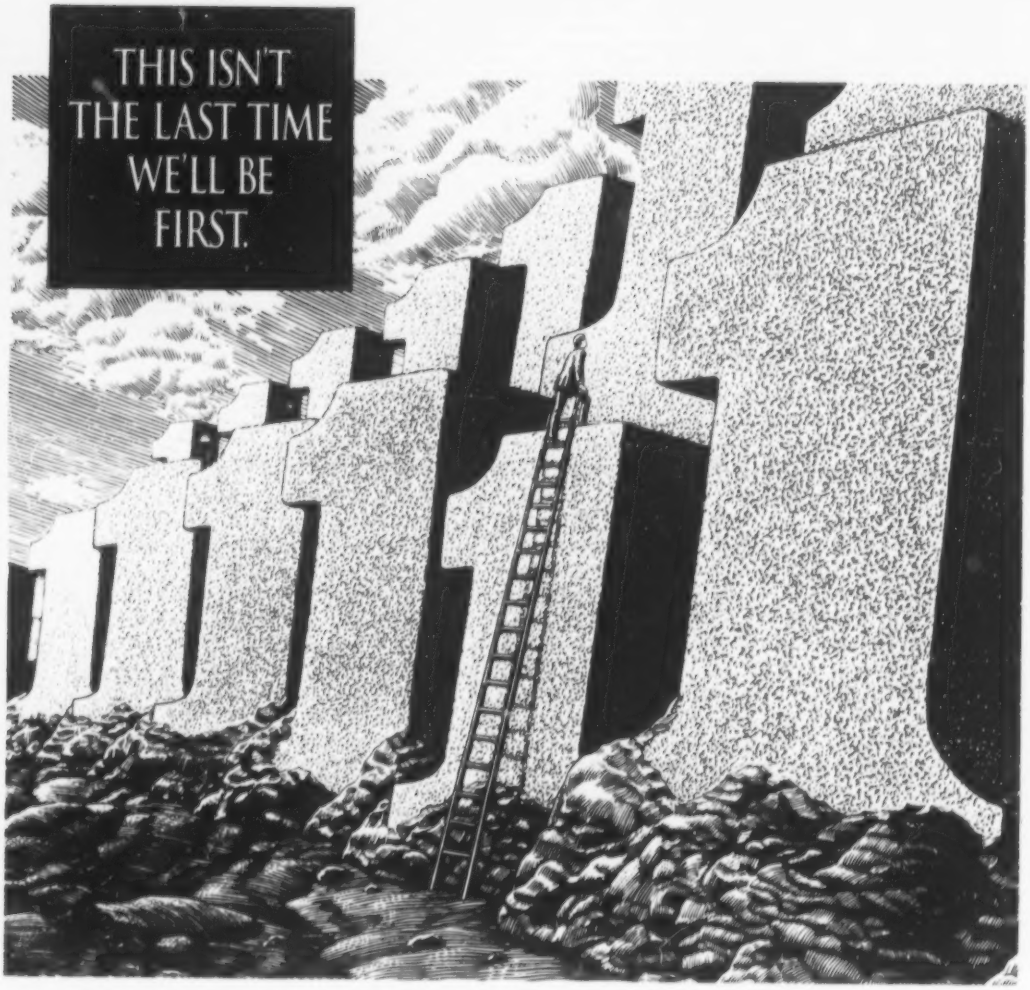
Failure to keep in mind these fundamental principles of world trade led to the passage of the Smoot-Hawley Tariff Act in June 1930. Along with fiscal and monetary policy mistakes, this is widely blamed for turning the recession of 1930 into the Depression of the 1930s.

Cheer Up—Things Will Improve!

With the hope, then, that business, consumers and government will do the right thing, Chemical Banking's economic forecast for 1992 expects growth to pick up in the current quarter, then gradually speed up in the spring and summer, ending up the year at a respectable (but not spectacular) clip of close to three percent. Business, it is hoped, will soon conclude that its payrolls have been thinned enough, and that, if anything, some additions might soon be needed. Consumers, in turn, will believe that the worst of these layoffs is past, and that their jobs are secure enough to allow them to satisfy some of their pent-up demands by returning to the nation's stores.

Most important, elected officials will display leadership in crafting an economic program that at once brightens people's attitudes, yet does not either overstimulate the economy, nor try to improve our lot by shutting out other countries' goods.

Hope springs eternal. ■



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